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IN THE

Supreme Court of the United States.

OCTOBER TERM, 1951

No. 693.

NAHUM BIRNBAUM, MORRIS J. LUTTERMAN and HANA D. LUTTERMAN, co-partners, doing business under the firm name and style of Birnbaum & Co., suing on their own behalf and on behalf of all similarly situated stockholders of NEWPORT STEEL CORPORATION, and on behalf of NEWPORT STEEL CORPORATION,

Plaintiffs-Petitioners,

—against—

NEWPORT STEEL CORPORATION, WILPORT COMPANY, C. RUSSELL FELDMANN,

Defendants-Respondents,

and

C. F. STAMM, et al.,

Defendants.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

NATHAN B. KOGAN,
Attorney for Petitioners,
99 Wall Street,
New York, N. Y.

IRVING CONSTANT,
Of Counsel.

THE COURT PRESS, N. Y. C.

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NAHUM BIRNBAUM, MORRIS J. LUTTERMAN and HANA D. LUTTERMAN, co-partners, doing business under the firm name and style of Birnbaum & Co., suing on their own behalf and on behalf of all similarly situated stockholders of NEWPORT STEEL CORPORATION, and on behalf of NEWPORT STEEL CORPORATION,

Plaintiffs-Petitioners,

—against—

NEWPORT STEEL CORPORATION, WILPORT COMPANY, C. RUSSELL FILDMANN,

Defendants-Respondents,

and

C. F. STAMM, et al.,

Defendants.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

To the Honorable, the Chief Justice and the Associate Justices of the Supreme Court of the United States:

Plaintiffs-Petitioners Nahum Birnbaum, Morris J. Lutterman, and Hana D. Lutterman respectfully pray the issuance of a writ of certiorari to the United States Court of Appeals for the Second Circuit to review a judgment and decision of that Court affirming an

order and judgment entered by the United States District Court for the Southern District of New York on May 28, 1951, which dismissed the complaint herein for failure to state a cause of action.

Jurisdiction.

The judgment of the Court of Appeals was entered on January 10, 1952. The jurisdiction of this Court is invoked under Title 28 United States Code, Section 1254, 62 Stat. 928, and Section 27 of the Securities Exchange Act of 1934, Title 15 United States Code, Section 78aa, 48 Stat. 902, as amended.

Opinions Below.

The opinion of the District Court (Kaufman, S. H., *Dt. J.*) is reported in 98 Fed. Supp. 506. The opinion of the Court of Appeals for the Second Circuit (Swan, L. Hand, and A. N. Hand, *Ct. JJ.*) is reported at 193 F. 2d 461.

Questions Presented.

1. Do §10 (b) of the Securities Exchange Act and Rule X-10B-5 of the Securities and Exchange Commission grant protection to investors defrauded in connection with a purchase or sale of securities even though they are not themselves purchasers or sellers?

2. Do §10 (b) and Rule X-10B-5 govern fraud upon minority stockholders perpetrated by a fiduciary who breaches his duty in connection with the sale of his controlling shares of stock?

Statute and Rule Involved.

Section 10 (b) of the Securities Exchange Act (15 U. S. C. §78j (b) 48 Stat. 891) provides:

> "SEC. 10. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> * * * *
>
> "(b) To use or employ, in connection with the purchase or sale, of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

Rule X-10B-5 of the Securities and Exchange Commission (17 Code Fed. Regs. §240.10b-5) provides:

> "Rule X-10B-5. Employment of Manipulative and Deceptive Devices.
>
> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange—
>
> "(1) To employ any device, scheme, or artifice to defraud;
>
> "(2) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements

made, in the light of the circumstances under which they were made, not misleading; or

"(3) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security."

Summary Statement of Matter Involved.

Plaintiffs are minority stockholders of defendant Newport Steel Corporation ("Newport" hereafter), and sue to recover for Newport and all its stockholders $4,000,000 in illegal profits made by defendant Feldmann through the device of a sale of his controlling Newport stock.

The allegations of the complaint dismissed below are as follows:

One Feldmann was President and Chairman of the Board of Directors of Newport and owned or controlled 400,000 shares, or 40%, of Newport's outstanding stock. He thereby dominated and controlled Newport and its Board of Directors (R. 5). The remaining outstanding stock of Newport is held in numerous small holdings by several thousand stockholders widely scattered in residence (R. 5). An over-the-counter market for the stock existed, at prices of approximately $9 to $11 per share.

In August 1950, Follansbee Steel Corporation made a firm offer for a merger of Newport with Follansbee on terms highly profitable to all stockholders of New-

port (R. 5). Feldman concealed this offer and in letters to the shareholders misrepresented the nature of the negotiations with Follansbee (R. 20-21). Feldmann then rejected the Follansbee offer for the purpose of taking advantage of an opportunity to make an even greater personal profit by selling his own shares without benefiting the other stockholders of Newport (R. 5-7).

Feldmann's scheme was to sell, not the assets of Newport since then all the stockholders would share in the proceeds, but his own personal shares for the sum of $8,000,000—about $22 per share, or more than twice the market value of the stock (R. 8-9). Wilport Company, the purchaser, obtained control of Newport and its assets by buying Feldmann's 40%. On August 31, 1950, the date of Feldmann's sale of his stock to Wilport, Feldmann and his entire Board of Directors resigned from Newport, and Wilport named its own Board of Directors to manage and control Newport (R. 10, 22-23).

Wilport is a Delaware corporation, organized in August, 1950, for the sole purpose of purchasing the Newport stock. It is the "dummy" creature of approximately ten manufacturing companies which were willing to pay high, in a period of steel shortages, for the steady supply of steel for their manufacturing operations which they would divert from the regular customers of Newport (R. 8). As Feldmann knew, Wilport and its components paid him at least $4,000,000 more than the fair market price of his stock in order to gain control of Newport, and change its course of business to that of a captive supplier whose sole function would be to satisfy the needs of Wilport and its components in a steel-scarce period.

The effect was, in part, to destroy Newport's goodwill in the trade and its opportunity to develop long-range contracts which would insure its future (R. 11-12).

The rejection of the Follansbee offer and the sale by Feldmann to Wilport were effected without notice to the stockholders of Newport and by false and misleading statements sent through the mails to the Newport shareholders by the various defendants herein (R. 9-10, 13-14, 20-27).

The courts below have held that although a fraudulent scheme was alleged, §10 (b) and Rule X-10B-5 extend protection only to investors who stand in the position of parties to a sale transaction as purchasers or sellers of securities, and that plaintiffs and Newport, members of the public and investors, are not protected by §10 (b) and Rule X-10B-5, even though a sale of securities by their fiduciary was the means of perpetrating a fraud upon them. The holding of the Court was that §10 (b) has "no relation to breaches of fiduciary duty by corporate insiders resulting in fraud upon those who were not purchasers or sellers" (R. 72; 193 F. 2d at p. 463).

Specification of Errors to Be Urged.

The Court below erred in

(1) Interpreting §10 (b) and Rule X-10B-5 so as to require proof of privity between plaintiffs and defendants, and thus to give no protection to the public and investors.

(2) Deciding that §10 (b) and Rule X-10B-5 do not apply to fraud practiced by a corporate fiduciary

upon his minority stockholders in connection with a sale of his securities.

Reasons Relied on for Allowance of the Writ.

1. This Second Circuit decision is in direct conflict with a decision of a District Court in the Third Circuit, *McManus* v. *Jessup & Moore Paper Co.*, Civil No. 8015 (D. C. E. D. Pa. 1948). The square conflict between the two cases is noted in Loss, *Securities Regulations* (Little, Brown & Co., 1st Ed., 1952), Chap. XI, p. 841; note 104.

2. The Court below has decided an important question of federal law which has not been, but should be, settled by this Court. The decision construes §10 (b) of the Securities Exchange Act, and not merely Rule X-10B-5. The words of the Rule, "in connection with the purchase or sale of any security", are copied directly from §10 (b), and the operative words are those of Congress. This novel case is the only one where, to our knowledge, a court has limited a section of the Securities Exchange Act so as to make impossible under that statute the promulgation of rules in the interest of the public and investors. It does not merely deny private rights. It construes the statute so that neither investors nor the S. E. C. may enjoin or otherwise seek relief against such frauds.

3. The Court below, in narrowly examining §10 (b) to discover limitations, adopted an approach hostile to the very purposes of the Act. The Securities Act of 1933 (15 U. S. C. §77 *et seq.*), the Securities Exchange Act of 1934 (15 U. S. C. §78 *et seq.*), and the Public Utilities Holding Company Act of

1935 (15 U. S. C. §79 *et seq.*) are all broadly remedial and should be read to effectuate their purpose of protecting investors. In *Kardon* v. *National Gypsum Co.*, 69 Fed. Supp. 512 (D. C. E. D. Pa. 1946), and *Fischman* v. *Raytheon Manufacturing Co.*, 188 F. 2d 783 (2d Cir. 1951), this approach was understood and used by Judges Kirkpatrick and Frank, and in *S. E. C.* v. *W. J. Howey Co.*, 328 U. S. 293, 301 (1946), this Court stated, with regard to the Securities Act of 1933: "The statutory policy of affording broad protection to investors is not to be thwarted by unrealistic and irrelevant formulae." Indeed, it was for the purpose of effectuating the provisions of the Act that the *Kardon* and *Fischman* and other lower court cases have consistently held that §10 (b) and Rule X-10B-5 provide for private rights of action for any victim of a fraud in connection with the purchase or sale of securities, although the statute does not specifically provide for such rights.

Section 10 (b) is a fraud provision of the Securities Exchange Act, to be invoked only where there is a scheme to defraud. It is not a burden on legitimate businesses; it is not a provision governing the financial responsibility of a broker, or requiring the filing of information with the Commission, areas where a strict construction may be proper.

Even before the passage of the securities statutes, it was recognized that fraud statutes must not be narrowly construed. *People* v. *Federated Radio Corp.*, 244 N. Y. 33, 154 N. E. 655 (1926); *Smith* v. *Whiteaker*, 118 Ore. 656, 247 Pac. 1077 (1926); *cf. Deaver* v. *U. S.*, 155 F. 2d 740 (C. A. D. C. 1946), cert. den. 329 U. S. 766. In *People* v. *Federated Radio Corp.*, *supra*, the Court stated (244 N. Y. at p. 48, 154 N. E.

at p. 657) that "The words 'fraud' and 'fraudulent practice' in this connection should, therefore, be given a wide meaning so as to include all acts, although not originating in any actual evil design or contrivance to perpetrate fraud or injury upon others, which do by their tendency to deceive or mislead the purchasing public come within the purpose of the law."

Section 10 (b) of the Securities Exchange Act is necessary to the statutory scheme precisely because fraudulent practices and techniques are unpredictable, changing always in an effort to escape the law. For the lower court to rule that the kind of fraud against investors which is the subject of this suit was of no concern to Congress in this Act is certainly not the proper way to construe a protective statute. *S. E. C.* v. *W. J. Howey Co., supra; S. E. C.* v. *C. M. Joiner Leasing Corp.,* 320 U. S. 344 (1943); *Smolowe* v. *Delendo Corp.,* 136 F. 2d 231, cert. den. 320 U. S. 751 (1943).[1] Clearly, if broad procedural remedies are to be afforded the litigant in order to effectuate the purposes of the statute, *Deckert* v. *Independence Shares Corp.,* 311 U. S. 282 (1940), it is inconsistent

[1] Unconscionable breach of fiduciary responsibilities by corporate fiduciaries, including officers, directors, and controlling stockholders, was intended by Congress to be within the reach of §10 (b) and the Rules adopted thereunder. This view is supported by the legislative reports on the bills later enacted into law. The House Committee Report (H. Rep. No. 1383, 73d Cong., 2d Sess. (1934), pp. 5, 6, 13), emphasized that the Securities Exchange Act must extend the legal conception of a fiduciary relationship in order to protect the dependent position of the ordinary citizen. Corporate managers must be brought to a clearer recognition of their responsibilities as trustees of their corporations and the other stockholders. The Senate Committee Report (S. Rep. No. 792, 73d Cong., 2d Sess. (1934), p. 55) demonstrates the keen concern felt because of the flagrant betrayal of their fiduciary duties by directors and the intention of the Committee to put an end to such behavior.

to deny broad construction of the substantive rights which the statute is intended to enforce.

4. The decision below has established the requirement that a defrauded plaintiff must prove "privity" between himself and the defendant in a contract of sale in order to sustain a cause of action under the Act. It is perfectly clear that §10 (b), drawn as broadly as possible, was meant as a "catch-all" provision to provide against "all manipulative or deceptive methods" in connection with securities transactions. *Kardon* v. *National Gypsum Co.*, 69 Fed. Supp. 512, 514 (D. C. E. D. Pa. 1946).

It was this very requirement of privity, necessary for an action in common law fraud and deceit, which the various securities acts and regulations were designed to avoid.[2] The language of §10 (b) of the Act—"*in connection with* the purchase or sale of any security"—demonstrates the purposeful attempt of Congress to free a defrauded investor from the harshness of the "privity" doctrine, and to deal with fraud as broadly as possible. Yet, the Court below has held that this language binds the Commission and the public by the privity rule so that protection against fraud cannot be extended beyond the immediate parties to the fraudulent securities transaction.

The complaint herein alleges all the necessary elements of an action under §10 (b) and Rule X-10B-5. The defendants, through means of interstate commerce, have employed a fraudulent scheme and course

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[2] Examples of the attempts to free investors from the need to prove "privity" are §11 of the Securities Act of 1933 (15 U. S. C. §77k), §9 (e) of the Securities Exchange Act of 1934 (15 U. S. C. §78i (e)), and §18 of the Securities Exchange Act of 1934 (15 U. S. C. §78r).

of business which operated as a fraud upon plaintiffs and Newport, in connection with the purchase or sale of a security. Where, as here, the fraud complained of is effectuated by the sale of securities, and the seller is a fiduciary to those defrauded, protection under §10 (b) and Rule X-10B-5 should be extended. Section 10 (b) should not be judicially amended to apply only to the immediate parties to the purchase or sale.

5. The complaint herein did not seize upon the sale transaction from Feldmann to Wilport as something unconnected with the fraud; the sale itself was the instrument of the fraud and was the technique which resulted in the damage to Newport and its stockholders. Indeed, plaintiffs and Newport were parties to the sale transaction, for it was their property, control of the corporation and the value of its position in the steel industry, that was the subject of the sale. The lower court's decision limiting a cause of action under the Act to parties to a contract of sale only, is thus seen to be highly technical and not in accord with the expressed statutory intent of granting protection to the public and investors.

6. The decision of the Court below opens a great loophole through which corporate fiduciaries may defraud their minority stockholders. Even if the common law were to provide adequate substantive remedies in a situation such as this, the jurisdictional problems which the Act was meant to avoid are insuperable in a state court action. The securities statutes, with their provisions for nation-wide service of process, were intended to protect scattered security holders who could not protect themselves because of the inadequacies of state court jurisdiction. This case is

exactly the situation which the statute was meant to cure. The defendants herein are residents of states from Maine to California (R. 38-40). Newport is an Indiana corporation allegedly not presently doing business in New York (R. 4, 35-38). Wilport is a Delaware corporation (R. 4). Feldmann lives in New York (R. 4). The other stockholders are scattered all over the country, and an over-the-counter market exists in Newport's shares (R. 5). It would be impossible to bring all necessary parties before a court and to obtain full determination of the allegations of the complaint, except pursuant to the statutory provisions of §27 of the Securities Exchange Act, which provide for nation-wide service of process.

No such gap in the area of regulation was intended to exist by Congress. It is for this reason that §10 (b) was phrased as a "catch-all" provision intended to grant protection to the public and investors against all types of fraud. Neither §10 (b) nor Rule X-10B-5 should be bound by the strict construction given them by the Court below. *S. E. C.* v. *C. M. Joiner Leasing Corp., supra; Smolowe* v. *Delendo Corp., supra.*

7. Before the broadly remedial purpose of Congress to grant protection to the public and investors against all types of fraud is limited in accordance with the decision below, this Court should rule on the question. The issue herein is one of great public importance, since it will determine whether investors have any effective remedy against fraud by a fiduciary in connection with a purchase or sale of securities.

Conclusion.

Petitioners pray that a writ of certiorari issue to the United States Court of Appeals for the Second Circuit commanding said court to certify and send to this Court a transcript of the Record in this cause to the end that the same may be here reviewed and determined; that the judgment and decision of said Court of Appeals be reversed; and that Petitioners have such other relief as may be proper.

April 1952.

NAHUM BIRNBAUM, MORRIS J. LUTTERMAN
and HANA D. LUTTERMAN,
Petitioners,
By NATHAN B. KOGAN,
Attorney for Petitioners.

IRVING CONSTANT,
Of Counsel.